

13000 WATER'S-EDGE

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13010 WATER'S-EDGE - GENERAL

For taxable years beginning on or after January 1, 1988, taxpayers may elect to file on a water's-edge basis. Under a water's-edge election, affiliated foreign corporations are generally excluded from the combined report. However, the election does not supersede the concept of unity; it merely limits the unitary entities included in the report.

For a discussion on the concepts of the unitary method of taxation and its application by California, please refer to Title 18, CCR §25106.5 et seq. and FTB Pub. 1061, Guidelines for Corporations Filing a Combined Report. For discussion on corporations making a water's-edge election and the entities included in a water's-edge combined report, see R&TC sections 25111, 25110 and 25113.

**13020 PROCEDURES FOR PROCESSING WATER'S-EDGE CONTRACTS -
INTRODUCTION**

To make a proper water's-edge election, each taxpayer must enter into a contract with the Franchise Tax Board by filing a water's-edge contract at the time the original return is filed for the taxable year which the contract is to be effective. The water's-edge contract may not be entered into through an amended return (Regulation 25111-1(e)). Title 18, CCR §25111-1(e)(1) now defines the term original return as the last return filed on or before the due date (taking extensions into account) regardless of the form on which it is filed or however it may be denominated. If no return is filed by that date, the first return filed after the due date (taking extensions into account) is considered the original return.

For taxable years beginning in 1988 and 1989, form FTB 1115 was used to enter into a water's-edge contract. For taxable years beginning in 1990 and after, the form number was re-designated as form 100-WE, Water's-Edge Contract. This form must be attached to the original return for the first year the contract is to be effective.

For taxable years beginning on or after January 1, 2000, taxpayers filing on a water's edge basis are required to use the new Form 100W, California Franchise or Income Tax Return – Water's-Edge Filers. However, taxpayers electing water's-edge for the first time are still required to attach Form 100WE, Water's-Edge Contract, to their original returns even if they are using the new Form 100W.

Please be aware that there is no Form 100W for S corporations that have elected water's-edge treatment. That is, water's-edge S corporations must continue to file using Form 100S, California S Corporation Franchise or Income Tax Return, and attach Form 2426, Water's-Edge Cover Sheet, to the front of their returns.

For taxable years beginning on or after January 1, 1994, significant revisions were made to the water's edge provisions. These revisions included:

- Revocation of all contracts entered into for taxable years beginning prior to January 1, 1994
- Requiring new elections for banks and corporations desiring to file on a water's-edge basis for taxable years beginning on or after January 1, 1994
- Revision of the contract period from 60 months (five years) to 84 months (7 years)
- Elimination of the water's-edge election fee
- Elimination of the requirement for water's-edge taxpayers to file a Domestic Disclosure Spreadsheet
- Revisions to the termination provisions of the water's-edge election

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- Elimination of provisions that allowed the Franchise Tax Board to disregard a water's-edge election for specified reasons
- Addition of the "Substantial Performance" test in determining the validity of a contract

On October 31, 1998, Title 18, CCR §25111 and CCR §25111-1 were amended to provide relief for taxpayers who intended to make a water's-edge election but who failed to fulfill the procedural or statutory election requirements.

The amendments to Title 18, CCR §25111 and CCR §25111-1 retroactively modified the requirements for making a valid water's-edge election. Under the amended regulations, even if there has been noncompliance with one or more procedural or statutory requirements for making the election, a water's-edge election will be considered valid if the tax was computed on a water's-edge basis and there is additional objective evidence to support the conclusion that an election was intended. (An example of objective evidence would be filing of Form 100W, or any substantially completed water's-edge form attached to the return.)

The amendments to regulation Sections 25111 and 25111-1 added a "substantial performance" test to relax the strict criteria that formerly had to be met in order for a water's-edge election to be valid. This new test provides that if a taxpayer fails to attach a contract to its original return, the water's-edge election will still be considered valid if the tax was computed on a water's-edge basis and if there is additional objective evidence to support the conclusion that an election was intended. The regulation provides several examples that constitute objective evidence such as attaching to the original return one or more water's-edge forms (i.e., Forms 100-FEE-A, 2411, 2416, 2424, 2426), or attaching a statement to the original return indicating that a water's edge election was being made.

As stated above, all contracts entered into for taxable years beginning prior to January 1, 1994 were rescinded. Taxpayers wishing to continue filing on a water's-edge basis are required to make a new election for taxable years beginning on or after January 1, 1994. For more information, see Water's-edge Booklet 100-WE, which contains various instructions and water's-edge forms.

The MSA Technical Resource Section (TRS) was previously responsible for pre-screening all new contracts filed for taxable years beginning on or after January 1, 1994. This process resulted in identifying problems with water's-edge elections early in the audit process. However, as a result of the adoption of amendments to Regulations §25111 and §25111-1 in October 1998, TRS no longer pre-screens each contract before sending cases to the field. Audit staff is now responsible for verifying the validity of an election. However, staff may continue to seek the assistance of TRS specialists.

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13030 PROCESSING OF WATER'S-EDGE CONTRACTS

Form 2426, Water's-Edge Cover Sheet - Prior to 1993, Forms 100 and 100S contained a checkbox on the front page used by taxpayers to indicate whether water's-edge was elected. In numerous instances, the box was checked in error. The box was deleted for taxable year 1994 through 1996. The water's-edge box was again used on the corporate Form 100 for taxable years 1997, 1998 and 1999. For taxable years beginning on or after January 1, 2000, water's-edge taxpayers are required to use the new Form 100W and are no longer required to attach Form 2426 to the front of the return.

Form 2426 is still required to be attached to the front of the water's-edge returns being filed for the year 1999 and prior, and for all S corporation returns being filed on a water's-edge basis. In the past, this form was not always attached to the front of the return. If not attached, the return may inadvertently get processed and posted to BETS as a worldwide return. Accordingly, when scoping returns for audit, it is very important to review the return for a water's-edge contract. If a contract is found, make sure the contract information is posted to BETS (* * * * *). If not on BETS or you are unsure whether the contract is posted, contact a TRS specialist for assistance.

Affiliation or Name Changes - It is common for unitary groups to change key corporations under which a combined report was filed. For example, in one year a water's-edge election is filed under a particular taxpayer's name while in the subsequent year the election is filed under another name. The subsequent year may appear to be a first-year return without the proper forms, or it may appear as an invalid election. Usually when this occurs, the taxpayer will indicate that a change has transpired and will attach a list of entities included in the return. This list can be used to identify the original water's-edge taxpayer. A review of BETS and the taxpayer's list of entities covered by the election may also be used to identify these changes. If the key corporation has changed, a new water's-edge shell is created in BETS under * * * * * * * *, and the status is shown under * * * * * * * * as "transferred". This means that the water's-edge contract is still valid, but it was originally made under a different corporate number.

Deemed Election - A water's-edge election is a tax attribute which carries over to and is binding upon an acquiring corporation or a distributee of property in complete liquidation of a water's-edge taxpayer. In addition, if a non-electing affiliate is subsequently proved at audit to be a unitary member of the electing water's-edge group, the non-electing affiliate is deemed to have made a water's-edge election effective as of the date that it is proved to be unitary with the water's-edge group, and it is bound by the water's-edge rules for the remaining period of the contract. Therefore, before invalidating an election or accepting worldwide combination, consideration must be given to the deemed election rules and how the rules apply to the taxpayer.

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EXAMPLES:

- Corporation A filed on a water's-edge basis pursuant to §25110 for a period of 84 months beginning in 1994 and ending in 2000. Corporation B makes no water's-edge election and files its 1994 and 1995 returns on a worldwide basis. In 1996, audit determines A and B are unitary during this period. Accordingly, B is deemed to have made a water's-edge election effective as of the date of A's election in 1994.
- Same as (1) above except that B filed its 1996 return on a worldwide basis pursuant to §25101. B then files an amended return re-determining its tax liability on a water's-edge basis. In reviewing the 1996 amended return, our first impression is that B's water's-edge election is invalid. However, due to audit's determination that B was deemed unitary with A in 1994, B's amended return is proper.
- Corporation P has never made a water's-edge election and files its returns on a worldwide basis. T and subsidiary S were unitary and elect water's-edge treatment for a period of 84 months beginning in 1994 and ending on December 31, 2000. On September 30, 1996, T sold S to P. P and S were considered instantly unitary as of September 30, 1996. From September 30, 1996 to December 31, 2000, P is deemed to have elected and shall be subject to the terms of S's water's-edge election. However, S may terminate the election if certain criteria are met.

Other - The taxpayer may claim a proper election was made in an earlier taxable year. If this occurs, request all potential water's-edge returns to determine whether a valid election was made and if so, for which taxable year(s).

NOTE: ((* *)) = Indicates confidential and/or proprietary information that has been deleted.

13040 TERMS/ABBREVIATIONS

CONTRACT - Equivalent to California Form 100-WE, which was previously designated as form 1115

WATER'S-EDGE LISTING – A report maintained by TRS titled "Taxpayers Electing Water's-Edge"

CP – Group within BE Audit Technical Support responsible for processing water's-edge returns.

R&S - Research and Statistics

Water's-edge Stand Alone PC – Water's-edge database maintained in a computer in BES and a back-up computer in the Technical Resource Section.

13050 WATER'S-EDGE - FIRST YEAR ELECTIONS, CONTRACT ATTACHED

Form 100-WE contains the contract language used for elections made on or after January 1, 1994. The steps listed below should be considered in determining whether the taxpayer has made a valid election. The auditor should also apply the substantial performance test (added to Regulations §25111 and §25111-1) in evaluating the validity of an election.

1. Does the corporation name and number on the contract correspond to the corporation name and number shown on the face of the return? If yes, go to step (5). If not, go to step (2),
2. Review the return and taxpayer's BETS account to determine whether:
 - The taxpayer is making a new water's-edge election. If it is a first year return, proceed to step (3);
 - There is an existing water's-edge contract in effect; or
 - The return is actually a subsequent year of another taxpayer' election. If determined to be a subsequent year, contact TRS. The TRS will update BETS.
3. If the corporation name does not agree with the return, write the key corporation name on the top of the contract in pen. Proceed to step (4).
4. If the corporation number on the contract does not agree with the return, write the key corporation number on the top of the contract. Proceed to step (5).
5. The date entered (middle of the contract) should be the first day of the taxable year. Does the date entered on the contract agree with the beginning date of the taxable year shown on the face of the return? If yes, proceed to step (7). If not, proceed to step (6).
6. Call the taxpayer to obtain authorization to correct the date. Revise the date and put an "*" by the revision. At the bottom of the contract add a comment such as "*Revision authorized by Tom Smith, Controller, (916) 123-4567, on 10/20/94." Initial and date the comment. Proceed to step (7).
7. For taxpayers filing on a combined basis, check to see if the box in the middle of the contract is checked. If checked, verify (to the extent of available information) the water's-edge elector is the entity that can make an election on behalf of its affiliates included in the water's-edge combined report. A common parent of a controlled group that files a consolidated federal return, or the common parent wherever domiciled or organized, may file an election binding upon all members of the controlled group that are part of the water's-edge combined report group. Direct or indirect ownership of more

than 50% of voting stock establishes control. The common parent need not be a California taxpayer.

8. If the ultimate parent does not make the election, verify that separate contracts are filed for each taxpayer. An election might not valid if a contract for each member of the combined group is not attached to the combined report.
9. Proceed to **MAPM 13090**, Reporting - Water's-Edge Listing.

13060 WATER'S-EDGE - FIRST YEAR ELECTIONS, CONTRACT NOT ATTACHED

1. For 1994 and subsequent, corporations wishing to file on a water's-edge basis must make a new election by attaching a contract to the original form 100 or 100S for the first year the contract is to be effective. If a contract is not attached, the election may not be valid. However, even though not attached, an election will still be considered valid so long as the substantial performance test (SPT) outlined in Regulation §25111-1 is met. A thorough review of the return using SPT criteria should be performed in these instances. If no evidence of an election is apparent, access BETS * * * * *. These * * * * * are maintained by BE Audit Technical Support for keying and tracking water's-edge contract information. If SPT is not met and no information is found in * * * * *, go to step 2.
2. Review the BES contract file to ensure the contract was not inadvertently detached from the taxpayer's return during processing. Is the contract in the BES file? If yes, proceed to step (3). If not, proceed to step (5).
3. Make a copy of the contract. Leave the copy in the BES file, and review the original contract for evidence to determine if the contract was filed separately by the taxpayer or if the contract was detached from the return during processing. Examples of evidence include a "Received Date" stamp, staple holes, or fold creases. If you cannot determine that the contract was mailed separately, you must assume the contract was detached from the return during processing. Consult with your supervisor as to whether you should make this assumption. Was the contract filed with the return? If yes, proceed to step (4). If not, proceed to step (5).
4. Re-attach the contract to the return. Add a comment to the return such as "The contract was filed with the return. However, it was erroneously removed during processing. The taxpayer does have a valid election." Initial and date the comment. Proceed to **MAPM 13050**.
5. If the contract was not filed, or the contract was filed separately on a day other than the day the return was filed, proceed to step (7). If the contract was filed on the same day as the return, but in a separate envelope or in the same envelope as the return, proceed to step (6).
6. Re-attach the contract to the return. Add a comment to the return such as "The contract was filed on the same day of the return. [Explain the circumstances.] The taxpayer does have a valid election." Initial and date the comment. Proceed to **MAPM 13050**.
7. If there is no contract attached and there is no evidence of substantial performance, notify the taxpayer in writing that the attempted water's-edge election is not valid. Use the appropriate letter and proceed to step (9).
8. Hold the return for one month in case the taxpayer contacts you. After a month, attach the form from step (7) to the return. Give the return to support staff to have the entire return copied. Keep the copy.

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9. When the return is received from BES after processing, review the water's-edge listing to ensure the items you requested are properly completed. File the return copy in the "invalidated election" file located in TRS. Proceed to step (10).
10. The return with the invalidated election must go to the field. Complete form FTB 7024, Request for Field Action, items 1 through 8.

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13070 REPORTING - WATER'S-EDGE ELECTION PRE-1994

Pre-1994 water's-edge database is maintained on PCs *****

The following information should be entered on the WE Listing. If any information is incorrect, complete form FTB 6866, Bank and Corporation Tax - Water's Edge Information Processing Request, to correct the error. Always check the box "Process and Return to Technical Resource Section" and write your initials next to that line. Route the form to BES. When you receive the request from BES, ensure all requested changes were made. Re-route to BES, if necessary.

	FIELD	INPUT DATA
1.	Corporation Name	Corporation name on the return should agree with BETS.
2.	Corporation Number	Corporation number on the return should agree with BETS.
3.	Date of WE Election	The "date received" from the first-year return.
4.	Date WE Contract Begins	First day of the taxable year of the first-year return.
5.	Date WE Contract Expires	60 months after item 4. If a subsequent-year return, the effect of a Notice of Non-renewal must be considered.
6.	Status	Enter "Non-renewal" or "Invalid" as appropriate.
7.	Taxable year Ending	Month and year-end of the return.
8.	Amount of Tax Due	Tax assessed on the return, including AMT.
9.	Amount of Fee Due	Amount of the election fee. See note below.
10	Penalty Amount	Determined by BES.
.		
11	Interest Amount	Determined by BES.
.		
12	Total Assessed	Total of items 9, 10 and 11.
.		

Other fields on the listing are amounts paid. It is not necessary to review a field not described above.

[NOTE regarding the election fee: The taxpayer is required to file a form 100-FEE, Water's Edge Election Fee, and a form 100-FEE-A, Water's Edge Election Fee Supplemental Schedule. The form 100-FEE should be attached to the front of the return. BES removes the form 100-FEE during processing and files the form in CP. TRS receives the return after the

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form 100-FEE is removed. The form 100-FEE-A is attached to the return and should not be removed.

BES accepts the election fee amount from the form 100-FEE, as filed. If the fee amount on the form 100-FEE differs from the amount on the form 100-FEE-A, BES will make a copy of the form 100-FEE, which indicates the fee amount accepted, and will attach it to the return.

If the election fee (Field 9 above) differs from that indicated on form 100-FEE-A or no form 100-FEE-A is attached to the return, route the return to BES. Request a copy of form 100-FEE and attached it to the return.

The form 100-FEE-A should not be removed from the return. If you find a form 100-FEE-A in the file maintained in BES, re-attached it to the return.

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13090 WATER'S-EDGE - FOREIGN PARENT LIST

TRS is no longer updating the Foreign Parent list for taxable years beginning after 1994. However, information from the list for taxable year beginning on or before 1994 may be obtained from TRS.

13100 WATER'S-EDGE - BOX CHECKER RETURNS - BACKGROUND

"Box Checker" returns are defined as pre-1994, 1997-1999 forms 100 and 100S filed by general and apportioning corporations in which the taxpayer has incorrectly marked the water's-edge box indicating they are filing on a water's-edge basis when they in fact have not entered into a water's-edge contract.

13110 SUPPORT STAFF - PROCESSING WATER'S-EDGE FIRST-YEAR RETURNS

Under the direction of a Technical Resource Section (TRS) specialist assigned the water's-edge (WE) contract review function, the following tasks are performed by TRS support staff:

- 1) THE FOLLOWING APPLY TO TAXABLE YEARS BEGINNING ON OR AFTER 1994:
 - a) Review WE contracts involving one taxpayer.
 - b) Process WE contracts through BETS * * * * *
 - c) Refer all WE contracts involving more than one taxpayer or problem contracts to the TRS specialist assigned to the WE contract review function.
 - d) After reviewing a contract, make a copy for the retention file. File in alphabetical order.
 - e) Check for first-year contracts.
 - f) All returns are sent to Data Services.
 - g) If a water's edge election is invalidated, make copies of the entire return for the retention file.
 - h) If a contract is not in BETS, add the contract information using * * * * *.
 - i) Request returns from Data Services as needed.

Any Contract problems should be brought to the attention of TRS.

- 2) NOTICE OF NONRENEWAL (FORM 1116)
 - a) Check for Notices of Nonrenewal. If found, ensure it is processed through BETS * * * * *
 - b) Make a copy of the notices for the retention file. The original Notice of Nonrenewal stays with the original files.
- 3) DOMESTIC DISCLOSURE SPREADSHEET (DDS) LISTING

Revenue and Taxation Code §25401(d) required the filing of a DDS for certain banks and corporations electing to file on a WE basis. It was repealed for taxable years beginning on or after January 1, 1994. Revenue and Taxation Code §18634 was enacted effective for taxable years beginning on or after January 1, 1994. This law provided that any taxpayer (not just WE filers) with total worldwide assets in excess of \$200,000,000 was required to file an information return, Form 2427, Worldwide Affiliation Schedule. Section 18634 was since repealed for information returns due on or after January 1, 1996. The due date includes any approved extensions to file the information return. Thus taxpayers are no longer required to provide the department with information concerning worldwide affiliates if they file on a WE basis.

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13120 COMPLETION OF FORMS - CANCELLATION OF WATER'S-EDGE PENALTIES

Complete form FTB 5843, Cancellation of Liability, to abate or partially abate WE penalties.
Data entered on the form is as follows:

1. Taxpayer's Name
2. Corporation Number
3. Posting Control
4. Taxable year Ended
5. Transaction Date (Effective date of penalty assessed from BETS or the B&C Master File)
6. Revenue Code (Same as the one used to assess the penalty)
7. Penalty Code
8. Cancellation of Failure to Furnish Information
9. Amount of Penalty to be Abated
10. Reason for Cancellation
11. Requester Code and Auditor's Initials
12. Current Date

13130 WATER'S-EDGE FAILURE TO FURNISH INFORMATION PENALTY

R&TC § 25112 provides for the assessment of a failure to furnish information penalty relating to information required of taxpayers filing a WE election. The penalty may only be issued by NPA.

AMOUNT OF THE PENALTY

Each taxpayer that fails to furnish information described in R&TC §25112(b) within 60 days of a written request, may be assessed a penalty of \$1,000 for each taxable year the information was not timely furnished (R&TC §25112(a)).

Each taxpayer that fails to furnish information under R&TC §25112(b) within 90 days of notification by a bureau director or a supervising counsel, will be subject to an additional \$1,000 per month (or fraction thereof) not to exceed \$24,000 (R&TC §25112(c)).

Effective 1/1/2002, the immediate supervisor's approval is required anytime a failure to furnish information penalty is assessed.

The water's-edge failure to furnish information penalty can be assessed at the same time as other penalties (such as a delinquency penalty) on an NPA.

NOTICE OF PROPOSED ASSESSMENT

The penalty is assessed on form FTB 6830 BCT NPA Worksheet by entering the following:

- (1) Penalty Description - WE-INFO PEN
- (2) Amount of Penalty
- (3) NPA Paragraph

Interest is assessed from the date of the NPA.

NPA PARAGRAPH

Use this paragraph for initial failure to furnish information penalty:

"In accordance with Revenue and Taxation Code 25112(a), we have assessed a penalty for failure to supply information or documents as required under Section 25112(b). Each taxpayer shall pay a penalty of \$1,000 for each taxable year for which the information was not timely furnished."

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Use this paragraph for any increase in the penalty for failure to furnish information:

"In accordance with Revenue and Taxation Code Section 25112(c), we have assessed an additional penalty for failure to supply information or documents as required under Section 25112(b). Each taxpayer shall pay an additional penalty of \$1,000 per month for each taxable year for which the information was not timely furnished, not to exceed \$24,000 per taxable year."

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